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SUBJECT: Airline Expansion in South China

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(U) This document is sensitive but unclassified. Please protect accordingly.

¶1. (SBU) SUMMARY: Rich and populous South China has become an air traffic hotspot. To win market share, airlines in the region are sharpening their competitive edge by opening new routes, buying more aircraft, and expanding cooperation with other airlines. As the Chinese Government deregulates domestic civil aviation, an increasing number of foreign carriers and budget airlines have entered the regional market and now directly compete with major domestic airlines. A shake-out in this market is inevitable, given the number of companies that have been lured into it by the prospect for sharing in what seems to be an ever expanding demand for airline services. END SUMMARY.

#### Air Traffic to Grow in the PRD Region

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¶2. (SBU) The Pearl River Delta (PRD) region boasts one of China's fastest growing manufacturing centers. Spurred by strong economic performance, the demand for air transport in South China is growing rapidly. China's General Administration of Civil Aviation (CAAC) has predicted that air traffic in the PRD will grow by 15 to 20 percent each year through 2010. Airlines are fiercely competing to capture a larger share of the soaring air traffic market. (See Ref A which goes into challenges faced by airports in the PRD.)

#### China Southern Getting Stronger

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¶3. (SBU) China Southern Airlines carried 49.2 million passengers in 2006, up from 44.1 million in 2005. The airline's main hubs are in Guangzhou and Beijing.

Secondary bases exist in Urumqi (from which the airline just launched its new service to Jeddah, Saudi Arabia) and Shenyang. On March 28, China Southern inaugurated its Guangzhou-Dubai flight on the heels of the Guangzhou-Kathmandu route opened on February 5. China Southern also announced the scheduled opening of eight new international routes from Guangzhou to Yangon, Phuket, Siem Reap, Vientiane, New Delhi, Sendai, Sapporo, and Luanda later in the year. As these new routes are launched, the number of international outbound routes from Guangzhou will increase from 18 to 26. Weekly international flights will rise from 136 to 182, an increase of more than 30 percent. China Southern is expected to become a member of the SkyTeam airline alliance (Delta, Northwest Cargo) in the second half of 2007. To help support this expansion, the airline's president said China Southern planned to purchase 68 new aircraft by the end of 2007.

14. (SBU) China Southern has a 60 percent stake in Xiamen Airlines. Xiamen Airlines carried 7.76 million passengers and 110,000 tons of cargo in 2006, up 12.1 and 9.0 percent respectively, and has turned a profit for the 20th consecutive year. Xiamen Airlines has an all-Boeing fleet of 43 aircraft that currently fly 140 overseas and domestic routes. Fueled by regional economic development and increasing business ties between Xiamen and Taiwan (though, of course, without any direct flight connections), Xiamen Airlines plans to add 60 new Boeing 737-800 aircraft by 2013, as well as a few leased jets. As one of Boeing's most loyal customers, Xiamen Airlines is negotiating with Boeing for a purchase of 25 jets worth USD 1.8 billion. More routes will be opened to Southeast and Northeast Asia, and the airline's capacity will likely double in five years.

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15. (SBU) Approved by CAAC, China Southern is setting up a joint-venture airline, Chongqing Airlines, with the Chongqing Development and Investment Company. The new airline will involve a total investment of RMB 1.2 billion (USD 157 million). China Southern will invest RMB 720 million (USD 94 million) for a 60 percent stake and will also supply aircraft and technical support. Su Liang, Secretary of the Board of Directors of China Southern, told

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the consulate that Chongqing Airlines will be officially established on June 18, but there is no date (perhaps July) for when it will be ready to offer a full range of flights. (Comment: The June 18 establishment is likely a symbolic date tied to the 10th anniversary of Chongqing's designation as a directly administered city, like Beijing and Shanghai. End Comment.) The new airline initially will have three Airbus 320 aircraft and will operate domestic routes from Chongqing to Beijing, Shanghai, Guangzhou, and Lhasa. Chongqing Airlines will add other domestic destinations as its inventory of aircraft increases.

#### Shenzhen Airlines Triples Profits

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16. (SBU) Shenzhen Airlines posted a record profit of RMB 360 million (USD 46.5 million) in 2006, more than triple the previous year's result. Shenzhen Airlines President Li Kun credited the success to the carrier's May 2005 transition from a state-owned enterprise to a privately-run company. During its reorganization, the airline earned RMB 2.72 billion (USD 353 million) from the sale of a 65 percent stake, originally held by Guangdong Development Bank, to Bright Ocean Corporation and Huirun Investment International. Shenzhen Airlines has been China's leading private carrier since reorganization and the country's fifth-largest airline. Passenger service grew more than 24 percent year-on-year to 7.1 million, and the load factor rose nearly 78 percent. This year, Shenzhen Airlines

expects to maintain revenue growth of at least 40 percent and serve 10 million passengers. It continues to pursue its "3-6-9" strategy to expand its fleet to 70 in three years, 100 in six years and 160 in nine years. The airline took delivery of 12 aircraft last year and now operates 45 A320s and B737s. Shenzhen Airlines will likely add more flights from Shenzhen to other airline hubs like Guangzhou, Zhengzhou, and Shenyang.

¶7. (SBU) Shenzhen Airlines has partnered with Lufthansa Cargo AG and Deg-Deutsche (a large European development finance institution) to operate Jade Cargo International. Last December, Shenzhen Airlines signed an agreement with the U.S. Mesa Air Group to create a regional airline specializing in feeder airline services. Shenzhen Airlines is discussing another commercial aviation partnership with a Hong Kong company.

#### Ambitious HNA Group Ready to Win More Market Share

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¶8. (SBU) A source at HNA Group told ATWOnline that the company's next step is to integrate the regional operations of its subsidiary carriers to "grab two-thirds of China's regional market share by 2012." The paperwork/permits for HNA to form the Grand China Air Group (GCAG), which would integrate Hainan Airlines and six other subsidiaries, are near completion. Having obtained USD 25 million from investor George Soros, USD 60 million from Pan American World Airways, and RMB 1.5 billion (USD 194 million) from the Hainan Provincial Government, HNA Group Chairman Chen Feng said the group had successfully completed financing for GCAG and is now waiting for its public air transport enterprise license.

¶9. (SBU) On March 30, HNA Group launched a new regional airline, Grand China Express Air Co. Ltd., in Tianjian. The new airline will begin operation this September and will initially operate 78 routes linking 54 cities. By 2012, it plans to buy 100 commercial jets from Brazil's Embraer and fly on more than 450 domestic regional routes

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linking 90 cities.

¶10. (SBU) Hainan Airlines carried 14.39 million passengers and 198,700 tons of cargo in 2006, up 12.41 and 22.55 percent respectively. On April 12, the company announced that it recorded a net profit of RMB 181.6 million (USD 24.49 million) in 2006, a stark change from a loss of RMB 215.82 million (USD 21.92 million) in 2005. The airline plans to buy two Boeing 737s and one A319 aircraft worth a total of RMB 1.16 billion (USD 150.6 million), and plans to lease two A330s and two A319s this year. Hainan Airlines started operating an Osaka-Beijing route on March 25 by expanding a code share agreement with JAL, and a Beijing-St. Petersburg route on May 4. Reopening a direct flight from Beijing to Geneva is under consideration.

¶11. (SBU) With JAL as its sponsor, Hainan Airlines is applying for the membership in the OneWorld Alliance (with American Airlines) to compensate for its limited overseas connections. President Chen Feng announced that a taskforce had been established to help prepare the carrier to join the alliance. The application is expected to be approved in 2007. However, industry analysts put Hainan Airlines in an inferior negotiating position, as alliances are targeting carriers in Beijing, Shanghai, and Guangzhou, while Hainan Airlines is based in the southern provincial capital of Haikou. OneWorld Managing Partner John McCulloch has told the media that his group was also negotiating with China Eastern Airlines based in Shanghai.

¶12. (SBU) On March 8, a subsidiary of HNA Group, Yangtze River Express, started its inaugural air cargo flight from Massachusetts to Shanghai. It also launched a Shanghai-

Anchorage-New York-Boston cargo service. HNA Group is accelerating the development of its overseas route network as it tries to play a stronger role in the global market.

#### Foreign Airlines Eye the China Market: Cathay Pacific Links Up with Air China

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¶13. (SBU) Cathay Pacific, Swire Pacific, Air China, CNAC, and CITIC Pacific Limited reached an agreement to change the shareholder structure of Cathay Pacific, Dragonair, and Air China in 2006. Under the agreement, Dragonair will be wholly owned by Cathay Pacific. Air China acquires a 17.5 percent stake in Cathay Pacific, and Cathay Pacific doubles its shareholding in Air China to 20 percent. Dragonair will continue to operate under its own name, but with Cathay Pacific management. Cathay Pacific and Air China have developed closer cooperation on many fronts, including the establishment of an air cargo joint-venture in Shanghai.

¶14. (SBU) Cathay Pacific's first annual report after the restructuring showed a 24 percent rise in net profits in 2006. The Center for Asia Pacific Aviation (CAPA) commented that the radical airline ownership restructuring will unlock "fantastic synergies" for Cathay Pacific. CAPA believes that Cathay Pacific and Air China can potentially form the world's biggest combined carrier with a mix of private equity (via the Swire linkage) and government support (via Beijing). Eyeing the huge mainland cargo business, Cathay Pacific started cargo flights to Beijing in 2006 and added six more weekly flights to Shanghai in January 2007. On March 27, the CEO of Cathay Pacific announced the link with Air China and plans to establish a Shanghai-based cargo joint venture this year. He also cited "increasing competition" as the reason for Cathay and Dragonair's combined cargo volume decline in the first two months of 2007. The airline plans to add 11 more cargo planes by the end of 2009 as exports from China surge. Cathay Pacific expects to boost capacity by 10 percent in 2007, 15 percent in 2008, and 10 percent in 2009, with growth primarily in cargo services.

#### Deutsche Lufthansa Invests USD 1 billion in Shenzhen

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¶15. (SBU) Early in October 2004, Lufthansa Cargo established Jade Cargo International with Shenzhen Airlines

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and Deg-Deutsche. As the first cargo airline in China with foreign ownership, Jade Cargo International started operations with a commercial flight from Shenzhen to Amsterdam on August 5, 2006. It now operates twelve flights weekly from China to Europe. On March 16, 2007, the President of Lufthansa Cargo met with Shenzhen Mayor Xu Zhongheng and disclosed that Lufthansa had invested over USD 1 billion in Shenzhen. Jade Cargo will receive six new Boeing cargo planes in 2007 and will rapidly expand its route network in Asia, Europe, and America.

#### Budget Airlines Stir Up Aviation Market

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¶16. (SBU) CAPA predicted that budget airlines will take up 20 percent of the market share in the Asia-Pacific region by 2010. CAPA statistics show that passenger throughput for budget airlines increased by 55 percent in 2006, while airlines providing comprehensive services only registered 0.9 percent growth. As the Chinese Government deregulates the domestic civil aviation market, budget airlines are emerging and stirring up the market with their low fare strategy. Despite the existing industrial monopoly, outdated civil aviation policies, and airport capacity shortages, budget airlines should continue making headway in the market so as to be able to compete directly with major airlines.

## Chinese Spring Airlines Fined for Offering Cheap Tickets

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¶17. (SBU) Spring Airlines based in Shanghai, the first airline to announce a budget travel strategy in China, earned more than RMB 20 million (USD 2.6 million) in profits last year. A spokesman attributed this success to the company's slashing of fares by an average of 61.8 percent since its launch in July 2005. Fare reductions have contributed to an average occupancy rate of 94.4 percent, the highest of any Chinese airline. Spring Airlines' budget travel strategy has caused regulatory problems. The company was fined RMB 150,000 (USD 19,405) for selling over 400 one-yuan tickets on the Shanghai-Jinan route last year. The fine was for violating the pricing rule set by CAAC, which sets the lowest discount rate at 55 percent off the standard rate. This is not the first time Spring Airlines has been targeted by the authorities for offering cheap fares. The airline submitted a report to CAAC and the National Development and Reform Commission in 2005 requesting a more flexible pricing system, but never received a reply.

¶18. (SBU) The airline will place an aircraft purchase order worth RMB 4 billion (USD 517.5 million) for 10 Airbus A320s in 2007. Due to the capacity shortage at Shanghai Airport, Spring Airlines is planning to build its second home base in Hainan Province this year. Spring Airlines' routes from Shanghai to Guangzhou and Zhuhai are popular, and customers are expecting more routes to be opened in the Pearl River Delta region.

## Foreign Budget Airlines Expand Business

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¶19. (SBU) Thai AirAsia, a branch of the budget airline Air Asia, entered the China market in April 2005 by opening a Bangkok-Xiamen route. Since then, the route has enjoyed an average occupancy rate of 85 percent. Due to the rising number of tourists and business travelers, on March 25, Thai AirAsia increased the number of its Bangkok-Xiamen low fare flights from four to seven per week. This year, the airline plans to open two to four new routes in China. However, the Vice President of Air Asia blamed China's airport capacity shortages for raising the airline's operating costs and said the official aviation monopoly has been a barrier for opening new routes in China. As a result, Thai AirAsia has to operate on less traveled routes.

¶20. (SBU) Singapore's Tiger Airways launched its inaugural flight to the Chinese mainland with a Guangzhou flight on April 25, 2006. Since then, it has opened additional

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flights from Singapore to Guangzhou, Shenzhen, and Haikou. On March 25, 2007, an additional two weekly flights to Shenzhen and Guangzhou were added to its summer flight schedule to meet the strong demand for low fare air travel on these popular routes.

¶21. (SBU) Other budget airlines are also winging their way into long-haul territory. Oasis Hong Kong Airlines began to offer flights to London's Gatwick Airport on October 25, ¶2006. It hopes to expand its Hong Kong service to Oakland and Chicago this year. Oasis is taking aim at Cathay Pacific Airways by offering promotional one-way economy class fares for HK 209 (USD 27), compared with Cathay's current fare of about HK 530 (USD 68). Oasis' chief executive and founder Stephen Miller noted that Oasis is trying to coordinate its schedules and operations with those of other budget airlines in Britain and the United States. If it succeeds, Oasis could wind up forging the first links of a world-wide network of low-cost carriers. "It would be a sort of strategic alliance," said Miller. Oasis executives say they have met with counterparts from

Britain's easyJet, but an easyJet spokeswoman declined to confirm such talks.

COMMENT: CAAC Plays a Key Role

¶22. (SBU) As economic growth continues and average incomes rise, the tremendous growth in air travel demand will continue to make South China a hot spot for airlines. As airlines rapidly expand their business in the region, a price war can be expected in the near future. Problems with slot allocation and route networks will worsen and hinder commercial aviation development. CAAC will have to step up to reform China's civil aviation management system and create a healthy business environment in the aviation sector, otherwise growth may stall.

¶23. (U) This cable was coordinated and cleared with Consulate General Hong Kong and Embassy Beijing.

Airlines At-A-Glance: 2006

Airline	Passengers	Cargo (tons)	Potential Alliance
China Southern	49.2 million	851,580	SkyTeam
Cathay Pacific	18.1 million	1,308,000	OneWorld
Hainan Airlines	14.39 million	198,700	OneWorld
Xiamen Airlines	7.76 million	110,000	SkyTeam
Shenzhen Airlines	7.05 million	107,000	
Tiger Airways	1.3 million		
Spring Airlines	1.13 million		
Thai AirAsia	1.13 million		

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